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Financial Markets

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research & Planning Division

Friday (Noon) Jan. 23, 1981

This week, financial markets were dominated by three factors: continuing assessment of the money stock data reported last Friday, the impact of the transfer abroad of Iranian financial assets, and the unexpectedly strong real GNP and inflation numbers. On balance, most rates moved somewhat higher over the week.

As noted in last week's letter, the multibillion-dollar Iranian transfer potentially could have been very disruptive to the funds market. Fortunately, adroit handling of the problem by the Federal Reserve made the impact minimal. (Occasionally it is useful to pause and reflect on the benefits of having a competent central bank!)

The most disturbing factor of the week for the credit markets was the Wednesday report that real GNP grew at a surprisingly strong 5% rate in the fourth quarter, while inflation as measured by the GNP deflator accelerated to an 11.2% rate. The markets, always sensitive to inflation news, reacted sharply. In addition, some participants failed to recognize the Fed's outright sale that day of Treasury bills (a permanent drain of reserves) as a technical operation. (Caution: there is a high probability that the Fed will need to undertake another outright sale in the next week or two for strictly seasonal reasons.)

Though the adverse impact of the GNP numbers on the near-term interest rate outlook cannot be denied, they also contain a constructive message. With the aid of hindsight it is clear that the economy was far more robust in the second half of 1980 than anyone--including the Fed--imagined. That strength was reflected immediately in the strong demand for money. Adhering to its monetary aggregates targets, the Fed promptly moved to a restrictive posture, rather than temporarily accommodate the expansion, as would have happened under its old operating procedures. Though the new reserves-oriented approach makes financial markets extremely volatile, before too long it should produce palpable benefits.

However, monetary aggregates targeting is a dicey game when NOW accounts are being introduced--witness the $9.9 billion increase in NOWs during the first week in January! As noted in last week's letter, interpretation of the aggregates is difficult without knowing the source of the inflows into NOWs. For what it is worth, data suggest that the November 1978 authorization of NOWs in New York and New Jersey lifted the growth rate of M-1B by almost 5% relative to M-1A in the first quarter of 1979. The growth differential declined to a negligible level by the fourth quarter of 1980, indicating that the shift was by then essentially complete. Thus the current distortion will probably be over by year-end; but in the near term, M-1B growth is likely to be very stong, with M-1A much weaker. In this setting the Fed will probably focus mainly on M-2, which is not affected by the shift to NOWs. (Warning: the published M-2 data include nonseasonally adjusted money market mutual fund shares, which are generally very strong in January.)

William C. Melton

Note: The full text of this letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

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Market Yields

	1/23/81	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	20.00%	20.00%	15.25%
Effective since	1/9/81		
Discount Rate at Federal Reserve Bank	13.00	13.00	12.00
Federal Funds	18.75	19.75	14.00
Repurchase Agreements	18.25	19.00	12.40
U.S. Treasury Issues			
Bills			
3 months	16.44	16.00	12.87
6 months	15.94	15.40	12.98
1 year	14.63	14.00	12.36
Coupons			
2 years	13.68	13.20	11.82
4 years	13.14	12.80	11.04
7 years	12.84	12.70	11.05
10 years	12.79	12.50	11.09
Long Bond	12.35	12.20	10.96
Negotiable Certificates of Deposit-Secondary Market			
1 month	18.50	18.65	13.50
3 months	17.85	17.85	13.55
6 months	16.45	16.25	13.75
1 year	15.25	14.90	13.25
Banker's Acceptances			
1 month	18.10	18.65	13.30
3 months	17.85	18.05	13.60
6 months	16.40	16.20	13.85
Eurodollar Deposits			
1 month	19.00	19.75	14.25
2 months	19.13	19.25	14.44
3 months	18.75	18.88	14.63
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	16.00	18.25	12.50
1 month	17.50	17.00	13.00
3 months	16.50	16.25	12.00
Bank Holding Companies			
1 month	17.75	18.25	13.05
Dealer Placed:			
3 months	14.00	17.25	13.15
New AA Corporate Utility Bond	14.75	14.75	12.40
Tax Exempt			
6 month Project Notes	7.55	7.15	5.85
1 year AAA Bond	6.85	7.00	NA
5 year AAA Bond	7.00	7.20	NA
20 year AAA Bond	9.15	8.60	7.00

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

Cable Address:
"IrvingBank" Telex: I.T.T. 420268 • R.C.A. 232241
W.U.I. 62832 • French 82629